

APPEALS INDUSTRY SPECIALIZATION PROGRAM

SETTLEMENT GUIDELINES

INDUSTRY: Construction/Real Estate

ISSUE: Retainage Payable

COORDINATOR: Stephen L. Howard

TELEPHONE NUMBER: (972) 308-7316

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APPROVED:

for Thomas C. Lillie
DIRECTOR, APPEALS LMSB SPECIALTY PROGRAM

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Date

Andrew E. Blanche
DIRECTOR, APPEALS LMSB OPERATING UNIT

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Date

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APPEALS SETTLEMENT GUIDELINES CONSTRUCTION/REAL ESTATE INDUSTRY

RETAINAGE PAYABLE

ISSUE

Whether under section 460 a taxpayer may defer deducting retainages payable until paid, thereby deferring gross receipts and gross income under the percentage of completion method of accounting.

EXAMINATION DIVISION'S POSITION

FACTS

A tax alert/advise has been circulated in the accounting and tax preparation community which asserts that taxpayers who are required to use the percentage of completion method of accounting (PCM) may defer income by excluding retainages payable from recognized contract costs.

Under the PCM, the cumulative gross receipts from a long-term contract for any tax year is computed by multiplying the contract's "total contract price" by its "completion factor." A contract's completion factor is a fraction whose numerator is "cumulative allocable contract costs actually incurred through the end of the current tax year" and whose denominator is "estimated total allocable contract costs." The current year's gross receipts from any long-term contract is computed by subtracting the cumulative gross receipts computed for the immediately preceding tax year from the cumulative gross receipts computed for the current tax year.

By excluding retainages payable from recognized costs, the completion factor is smaller, thus reducing current year income recognition. The effect is to defer contract income recognition to later years.

In support of the proposition that retainages payable are not required to be recognized as current costs, the tax alert/advise cites Shepherd Construction Co., 51 T.C. 890 (1969),

where the Tax Court held that a highway contractor improperly deducted a portion of subcontractors' expense retained by the contractor. In reaching its conclusion the court relied on the fact that "[a]t the time of the partial payments to its subcontractors, all events had not occurred which rendered petitioner's obligation to pay some amount of the retainage to them fixed and certain. [citations omitted]" The court also determined that the change in the petitioner's treatment of retainage was properly characterized as a change in method of accounting.

LAW AND DISCUSSION

In the Construction Industry Coordinated Issue Paper entitled Percentage of Completion - Timing of Cost Recognition, effective 3/21/97, we held that contractors cannot postpone the recognition of costs they incur for the work of their subcontractors in order to postpone income under the percentage of completion formula of section 460.

Section 460 requires most large long-term contracts to be accounted for under the PCM. The PCM requires income from the contract to be reported over the life of the contract and requires contract expenses to be deducted in the year that they are incurred.

Because the recognition of income under the PCM formula is based on the amount of costs incurred to date, deferring costs will also delay the recognition of income. Given this potential benefit, contractors have been attempting to postpone the time that certain costs are deemed incurred under the economic performance rules.

Generally speaking, most taxpayers wish to take deductions as soon as possible (the reverse of the situation presented here). The Code protects against abuse in this regard by providing that an accrual basis taxpayer cannot treat the amount of any liability as incurred until the all events test is met. See, e.g., section 461(h)(4). The all events test is met with respect to an item if all events have occurred which determine the fact of the liability and the amount of the liability can be determined with reasonable accuracy.¹ Id. See also United States v. General Dynamics Corp., 481 U.S. 239 (1987); United States v. Hughes Properties, Inc., 476 U.S. 593 (1986).

Section 461(h)(1) added "economic performance" as the third prong of the all-events test. As modified by § 461(h)(1), the all-events test for an item is not treated as satisfied any earlier than the taxable year in which economic performance occurs.

¹The amount of the liability to the subcontractor may not be determinable with reasonable accuracy until the amount is billed by the subcontractor.

Section 461(h)(2) provides the time when economic performance is deemed to occur for various types of liabilities. With respect to liabilities for services and property provided to the taxpayer, section 461(h)(2)(A) provides that economic performance occurs as the taxpayer receives the services or property. See also Treas. Reg. § 1.461-4(d)(2)(ii).

Unauthorized Change in Method of Accounting

Contractors have been asserting that Treas. Reg. § 1.461-4(m)(2) authorizes them to change their accounting method for subcontractor expenses. That section states in part:

For the first taxable year beginning after December 31, 1991, a contractor is granted the consent of the Commissioner to change its method of accounting for long-term contract liabilities described in paragraph (d)(2)(ii) of this section and payment liabilities described in paragraph (g) of this section...to comply with the provisions of this section.

Treas. Reg. § 1.461-4(m)(2) provides, in relevant part, automatic consent for changes in method of accounting for long-term contracts to comply with the economic rules under Treas. Reg. § 1.461-4. As discussed in detail above, the method changes are not being made to comply with section 461(h).

In Shepherd Construction Co. v. Commissioner, 51 T.C. 890 (1969), the Tax Court determined that a highway contractor improperly deducted a portion of subcontractors' expense retained by the contractor. In reaching its conclusion the court relied on the fact that "[a]t the time of the partial payments to its subcontractors, all events had not occurred which rendered petitioner's obligation to pay some amount of the retainage to them fixed and certain. [citations omitted]". Shepherd Construction, 51 T.C. at 898. The court also determined that the change in the petitioner's treatment of retainage was properly characterized as a change in method of accounting:

Our decision requires a determination of the proper time, under petitioner's accrual method of accounting, for the deduction of a business expense, which is concededly ordinary and necessary. Both parties agree that this determination ultimately depends upon a proper application of the "all events" test established in United States v. Anderson [1 USTC ¶ 155], 269 U.S. 422 (1926), and incorporated into section 1.461-1(a)(2), Income Tax Regs.

* * * *

Section 446(b) gives respondent the broad discretion to compute taxable income under a method of accounting which, in his opinion, clearly reflects income. See Lucas v. American Code Co., 280 U.S. 445 (1930). We cannot say that respondent has abused his discretion when, on this record, we discern no significant differences in the terms of payment under the prime contracts and the subcontracts sufficient to justify petitioner's inconsistent treatment of retainages provided for under the two types of contracts. **The consequence of the exclusion from income on the one hand and the inclusion of an expense on the other was a distortion of petitioner's annual profits.** See and compare Wright Contracting Co., 36 T. C. 620 (1961), affd. 316 F. 2d 249 (C.A. 5, 1963), certiorari denied 375 U. S. 879; Ohmer Register Co. v. Commissioner, 131 F. 2d 682 (C. A. 6, 1942).
“Emphasis added”

As can be seen, in the Shepherd case, the taxpayer excluded retainage receivables from income, but deducted retainages payable. The court held that for an accrual basis taxpayer the exclusion from income on the one hand and the inclusion of an expense on the other was a distortion of petitioner's annual profits.

Under the PCM, costs that are allocable to a contract are taken into account in computing taxable income in the year the costs are incurred. Treas. Reg. §1.460-4(b)(2)(iv). To determine the completion factor, the taxpayer must take into account the cumulative allocable contract costs that have been incurred (defined under Treas. Reg. §1.460-1(b)(8) as the “all events” test of Treas. Reg. §1.461(a)(2) regardless of the taxpayer’s method of accounting) through the end of the taxable year. Treas. Reg. § 1.460-4(b)(5)(ii). See also Notice 89-15 Q&A 32 and 33, 1989-1 C.B. 634, 642 (Service position before effective date of section 460 regulations).

Accordingly, under section 460, a taxpayer may not defer deducting retainages payable, until paid, in the numerator of its percentage of completion computation. Retainages payable are deductible when the all events test is met and economic performance has occurred; for long-term contract expenses, economic performance occurs as services or property is provided, or, if earlier, as the taxpayer makes payment. Treas. Reg. §1.461-4(d)(2)(ii).

Change in Method of Accounting Issues

A change from including retained amounts in the cost incurred for determining a contract's percentage of completion to excluding retained amounts for that purpose, or vice versa, is a change in method of accounting subject to section 446. Section 446(e) and Treas. Reg.

§ 1.446-1(e)(3) require a taxpayer to obtain the Commissioner's consent before changing its method of accounting, regardless of whether the present or proposed method is proper or is permitted under the Code or regulations.

The automatic consent provided in Treas. Reg. 1.461-4(m)(2) for the first taxable year beginning after December 31, 1991, does not provide consent to a taxpayer to begin excluding previously included retained amounts from the cost incurred for determining contract's percentage of completion. The automatic consent provisions of Treas. Reg. 1.461-4(m)(2) grants automatic consent to taxpayers in certain limited situations for the purpose of changing the taxpayer's accounting method to comply with the provisions of section 461. An improper change in accounting method (i.e. change from accrual cost recognition to improperly deferring cost recognition under the PCM) does not qualify for the automatic consent provisions of Treas. Reg. §1.461-4(m)(2). Accordingly, taxpayers seeking to make such a change must request advance consent under the normal procedures as described in Treas. Reg. §1.446-1(e)(2). If the taxpayer made such a change in method of accounting without the consent of the Commissioner, the taxpayer made an unauthorized change in method of accounting.

If the examiner is examining the taxpayer's tax return for the year of an unauthorized method change (i.e., taxpayer changes to excluding retained amounts from the cost incurred for determining a contract's percentage of completion), the examiner should reject the taxpayer's unauthorized change in method of accounting. Taxable income for the year should be recomputed on the method used by the taxpayer for the preceding year (i.e. retainage amounts included in the cost incurred for determining a contract's percentage of completion). The RAR should clearly state that the taxpayer made a change in method of accounting without having obtained the consent of the Commissioner, contrary to the requirement of section 446(e) and Treas. Reg. § 1.446-1(e), and that the reversal of the taxpayer's unauthorized change in method of accounting is being proposed. The RAR should also state that the method of excluding retained amount from the cost incurred for determining a contract's percentage of completion is an improper method of accounting since it is inconsistent with Treas. Reg. §1.461-4.

If the examiner is examining the taxpayer's tax return for a year subsequent to the year of such an unauthorized method change, or a year subsequent to the year the taxpayer adopted its current erroneous method of excluding retained amount from the costs incurred for determining a contract's percentage of completion, and the taxpayer is not eligible to change its method of accounting under Rev. Proc. 97-27, 1997-1 C.B. 689, the examiner should change the taxpayer's erroneous method of accounting to the proper method under the authority of section 446(b) and the related regulations. The RAR should state both the proper new method of accounting and that a change in method of accounting, subject to sections 446 and 481, is required. The RAR should also label the section 481(a)

adjustment. The change in method of accounting will ordinarily be made in the earliest year under examination and the entire amount of the positive section 481(a) adjustment should be included in the examiner's computation of the taxpayer's taxable income for the year of the method change.

If a taxpayer attempts to change from including retained amounts in the costs incurred for determining a contract's percentage of completion to excluding retained amounts for that purpose in an amended return (claim for refund) without having obtained the consent of the Commissioner, the taxpayer's claim for refund should be disallowed. The primary reason for disallowance is the lack of consent under section 446(e) and Treas. Reg. § 1.446-1(e)(3). See also, Rev. Proc. 97-27, 1997-1 C.B. 689, § 2.04. The secondary reason for disallowance is that the method of excluding retained amounts from the costs incurred for determining a contract's percentage of completion is inconsistent with the requirements of Treas. Reg. § 1.461-4.

CONCLUSION

Under section 460, a taxpayer may not defer deducting retainages payable until paid. Retainages payable are deductible when the "all events" test is met and economic performance has occurred. Economic performance occurs as services or property is provided or, if earlier, as the taxpayer makes payment. Treas. Reg. § 1.461-4(d)(2)(ii).

If a taxpayer changed from including retained amounts in cost incurred for determining a contract's percentage of completion to excluding retained amounts for that purpose, the taxpayer has changed its method of accounting for purposes of IRC § 446 and the regulations thereunder. Absent application of the automatic consent provision of Treas. Reg. § 1.461-4(m)(2)(i), a taxpayer may not change its method of accounting for federal income tax purposes without first obtaining the Commissioner's consent. Treas. Reg. § 1.461-4(m)(2)(i) does not apply to a change to exclude previously included retained amounts from the cost incurred for determining a contract's percentage of completion. Therefore, if a taxpayer changed its method of accounting without the advance consent of the Commissioner, the taxpayer made an unauthorized change in method of accounting.

SETTLEMENT GUIDELINES

The issue is whether under IRC § 460 a taxpayer may defer deducting retainages payable until paid, thereby deferring the recognition of gross income under the percentage of completion method (PCM).

Under the PCM, a taxpayer/contractor determines the current year's gross receipts from a long-term contract by multiplying the "total contract price" by the contract's "completion factor" for the current year ("cumulative gross receipts") and by subtracting from this amount the cumulative gross receipts for the immediately preceding year. The completion factor, which shows the percentage of completion, is the ratio of (1) the amount of allocable contract costs incurred by the end of the current year (the numerator) to (2) the estimated total contract costs (denominator). At issue in this paper is when retainages payable to subcontractors are incurred within the meaning of § 461, and thus, must be included in the numerator of the completion factor. Contract costs generally are treated as incurred in the taxable year in which the "all events" test of § 461 is met.

IRC § 461(a) provides that the amount of any deduction or credit shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

IRC § 461(h) and Treas. Reg. § 1.461-1(a)(2) provide that, under an accrual method of accounting, a liability {as defined in § 1.446-1(c)(1)(ii)(B)} is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which

- 1) all the events have occurred that establish the fact of the liability,
- 2) the amount of the liability can be determined with reasonable accuracy, and
- 3) economic performance has occurred with respect to the liability.

The first two requirements are referred to as the all events test. See IRC § 461(h)(4).

While this paper focuses principally on the "economic performance" aspect, Appeals Officers are cautioned to also carefully consider the first two requirements (the "all events" test) in determining when expenses are incurred within the meaning of IRC § 461.

Regarding the first requirement of the "all events" test, if all the events that determine the fact of liability do not occur until a taxable year after economic performance is met, a liability is not incurred under IRC § 461 until both of these requirements, as well as the reasonable accuracy requirement is met.

With respect to the "reasonable accuracy" requirement, the amount of the liability may not be determinable with reasonable accuracy where there is a legitimate dispute concerning

the amount.

For example, A renders services for which he charges \$10,000. B admits a liability to A for \$6,000 but contests the remainder. B may take into account only \$6,000 as an expense for the year in which the services were rendered. See Treas. Reg. §1.461-1(a)(2)(ii).

Where a taxpayer's obligations are set forth in a written agreement, the specific terms of the agreement are relevant in determining the events that fix the taxpayer's obligation to pay. See Decision, Inc. v. Commissioner, 47 T.C. 58 (1966), acq. 1967-2 C.B. 2. In order to fully analyze when a liability is incurred, the specific contractual provisions should be provided and analyzed. In Shepherd Construction Co., Inc. v. Commissioner, 51 T.C. 890 (1969), acq. 1969-2 C.B. 25, the court looked to specific terms of the contracts relating to acceptance in determining whether an accrual basis general contractor had incurred a liability for retainages withheld from its subcontractors prior to final acceptance and approval of the work performed.

The tax alert/advise, which has been circulated in the accounting and tax preparation community, cites Shepherd Construction Co., *supra*, as authority for deferring recognition of retainages payable. While the Commissioner has acquiesced in this decision, the case may be factually distinguishable from most cases involving the retainage issue. In reaching its decision the court relied heavily on the following two factual determinations:

1. Contract Terms

The court made a factual determination that under the prime contracts the subcontractor had no right to receive the retainages until final inspection and acceptance of the entire work under the contract and then only if the cost of removal of defective or unauthorized work did not exceed the total retainage. Under these contract terms, the court ruled that the "all events" test was not satisfied until the time of the final accounting (i.e. after final inspection and acceptance)

2. Inconsistent Treatment of Retainages

Perhaps even more persuasive was the petitioner's inconsistent treatment of retainages receivable and retainages payable. The taxpayer excluded retainages receivable from income but deducted retainages payable. The court held that for an accrual basis taxpayer, the exclusion from income of retainages receivable and recognition of an expense for retainages payable was a distortion of petitioner's annual profits.

Assessing the litigation hazards, if any, with respect to Shepherd Construction Co., supra, requires a factual comparison of the contract terms and accounting treatments of the respective cases. Settlement of cases involving legitimate issues with respect to the “all events” test will depend on the facts and circumstances.

In considering the legitimacy of an asserted dispute regarding the fact, amount, or economic performance of a retainage payable, it should be noted that generally, retainages payable represent “hold backs” of a contract specified percentage of the subcontract price pending completion of all, or agreed upon percentages, of the project. Accordingly, absent evidence to the contrary, retainages payable do not inherently represent “disputed” liabilities. Retainages payable, which satisfy the “all events” test, may not be deferred to a later year. However, if the retainages payable are the subject of a legitimate dispute, then the all events test may not have been met with respect to the disputed portion.

The determination as to whether retainages payable are the subject of a legitimate dispute is a factual issue, requiring careful scrutiny of the contract provisions, including:

- 1) whether the contract is for the provision of property, services, or both property and services;
- 2) the billing arrangements;
- 3) acceptance provisions;
- 4) retainage provisions; and
- 5) conditions relating to progress or periodic payments.

It should be emphasized, however, that recognition of contract costs under the PCM may not be delayed by postponing payment. In determining whether an expense has been incurred, the all events test shall not be treated as met any earlier than when economic performance occurs with respect to such item. See IRC §461(h)(1). In the case of any liability of a taxpayer that is an expense attributable to a long-term contract, subject to the PCM, economic performance occurs:

- a) as the services or property are provided; or, if earlier,
 - b) when payment is made to the person providing the services or property.
- Treas. Reg. §1.461-4(d)(2)(ii).

Accordingly, payment is not a requirement for recognition of contract costs under the PCM.

Summary

The appropriate timing for the recognition of retainages payable is governed by the “all

events” test as outlined in Treas. Reg. § 1.461-1(a)(2)(i) and IRC § 461(h). Whether a retainage payable has satisfied the “all events” test and should therefore be recognized as an incurred contract cost in computing income under the PCM depends upon the facts and circumstances. In assessing the hazards of litigation, if any, on this issue, particular attention should be given to the contract terms that determine the events that fix the taxpayer’s obligation to pay.

Accounting Method Changes

It should be noted that a change to the time a taxpayer consistently reports income or deducts expenses is a change to the taxpayer’s method of accounting, subject to the provisions of IRC §§ 446 and 481. Thus, a change in the way that retainages payable are reported could potentially be a change in accounting method.

For instance, if the taxpayer has consistently excluded retainages payable from recognized contract costs in computing income under the PCM and the examiner’s adjustment proposes to include retainages payable as a recognized cost in computing income under the PCM, such change would likely constitute a change of accounting method.

Any change of accounting method concerns can be addressed when you contact the Appeals ISP coordinator.